

ANNUAL EVALUATION REPORT
1 September 1997 – 30 September 1998

"Free Market for Lithuania's Prosperity"
Agreement No 181-A-00-96-90322

The Lithuanian Free Market Institute (LFMI) is an independent non-profit organisation founded in 1990 to promote the ideas of economic liberalism, based on the principles of individual freedom and responsibility, free market and limited government, as well as to formulate a sound and innovative approach to economic policy

The purpose of the USAID/LFMI project, "Free Market For Lithuania's Prosperity," is to provide independent expert input into the economic reform process in Lithuania and to promote the adoption of free market-oriented legislation for the purpose of creating an environment supportive of private business initiative and increasing the size and contribution of the private sector in the Lithuanian economy LFMI is pursuing these goals via policy advocacy and public education

In 1997 through 1998 LFMI undertook a series of activities to accomplish the goals of the project LFMI conducted high-quality research and policy analysis and submitted policy proposals in the following areas private pension insurance, privatisation and capital markets, tax and budgetary policy, private enterprise, and monetary policy

POLICY PROPOSALS VERSUS POLICY ACTION

1 Financial Infrastructure

In the area of financial infrastructure LFMI worked on the following issues

- 1.1 private pension insurance and supporting legislation
- 1.2 privatisation and capital markets
- 1.3 capital gains tax
- 1.4 leasing
- 1.5 bank accounts

1.1 Private pension insurance

The Law on Pension Funds is scheduled for adoption in parliament in the coming months The law will provide for the creation of fully funded private pension funds by introducing supplementary voluntary pension insurance This will not only facilitate retirement provision and provide relief with the public pension scheme but will have a profound impact on the development of the capital market The enforcement of the law is expected to be the first step in redesigning the fraying pay-as-you-go pension system into a viable scheme

LFMI was one of the first groups in Lithuania to promote the idea of fully-funded pension insurance through private pension funds and to draft the legal basis When official policy action was launched, LFMI contributed significantly to the preparation of a draft law on pension funds by generating high-quality research and policy solutions and conducting a focused dissemination campaign with a series of conferences, forums and media appearances The current version of the draft, in particular the provisions on the legal status and operational principles of pension funds, the pension insurance model, the form of ownership, and supervisory rules, are based largely on the LFMI's proposal Yet, the provisions regarding risk management mechanisms and guarantees need to be revised LFMI will continue to influence the policy debates at their final stage by testifying before decision-making bodies, appearing in the media, and holding a seminar to address the outstanding problems

Supporting legislation For the past few years LFMI was calling for setting the upper ceiling on social security contributions in order to promote legalisation of incomes, to provide a stimulus for people to receive higher earnings and to create real opportunities for middle-income individuals to ensure private retirement provision Earlier this year the government decided to set the upper ceiling for social security contributions at 3.5 times the country's average earnings as of January 1999 The ceiling will be reduced by 0.5 points as of the year 2000 Consistent with LFMI's position, the ceiling was not linked to payments into private pension insurance The proposal is under consideration in parliament

In addition, LFMI participated in designing a tax policy model applicable to private pension insurance. Amendments to the personal income tax law and the state social security law were prepared, providing for exemption of pension fund contributions from income and social taxes. The government proposed that contributions to private pension insurance in the amount of up to 25 percent of personal earnings be exempted from income and social taxes. This proposal will be debated in parliament alongside the pension fund law.

1.2 Privatisation

Following a few years of efforts to help improve the methods of privatisation and increase procedural and institutional transparency, LFMI initiated revision of the privatisation legislation in order to improve procedural rules and secure an extensive use of the stock exchange in the privatisation of state assets. Privatisation through the stock exchange is considered to be the most effective way of transferring public ownership to private hands. LFMI conducted research into the methods of privatisation and released an analytical policy study, which was disseminated among decision makers and private institutions. Also, LFMI drafted a project of amendments to the privatisation legislation, which was approved by the National Stock Exchange, the Securities Commission, and the National Financial Brokers Association. LFMI's activities brought about a significant change in the official approach to privatisation. The government began to rely more on privatisation through the stock exchange and reduced the level of discretion attached to tenders.

LFMI carried out an extensive dissemination campaign with a total of 27 media exposures to oppose a draft law on telecommunications which proposed a five-year monopoly in terrestrial telecommunications to the purchaser of the telecom. This decision coupled with along with the introduction of local telephone rates calculated on a per-minute basis were widely viewed as measures designed to augment the telecom's price tag. Despite public protests and a barrage of criticism from the country's economists, the law was passed and the sale of the Telecom was concluded through a privatisation tender. The tender was won by Amber Teleholdings, a consortium founded by the Swedish Telia and the Finnish Sonera.

1.3 Capital gains tax

On July 2, parliament passed the controversial amendments to the law on personal and corporate income tax, imposing taxes on dividends and capital gains unless they are reinvested. The imposition of capital gains tax prompted a barrage of criticism from stock brokers and market experts. LFMI came out in opposition to these amendments, arguing that the tax would hamper the development of the capital market and that any revenues generated by the tax would be offset by the administrative costs. LFMI consolidated efforts with the National Stock Brokers Association and market experts in order to revoke the tax.

As a result of the meeting with the veto-empowered President Valdas Adamkus, a compromise was reached which was overwhelmingly approved by parliament on September 29. A 15-percent capital gains tax was adopted instead of the original 29 percent, and a minimum tax-exempt level was set. The latter provision will allow small-scale participants in the stock exchange to invest tax-free.

1.4 Leasing

LFMI's efforts in the area of leasing are designed to prevent the introduction of excessive regulations and restrictions on leasing as well as to advocate replacement of tax regulations discriminating against leasing activity. To accomplish this objective, LFMI analysed a new draft law on leasing, which was proposed by the Economic Ministry. Based on the analysis and consultations with leasing companies, LFMI formulated recommendations concerning the draft law. According to LFMI, with minor changes to the Civil Code and tax laws, an appropriate legal framework for the leasing system can be completed. A new law is likely to jeopardise leasing activities by imposing severe and unjustified restrictions and government interventions. For instance, the draft law proposed to prohibit leasing for consumer purposes.

A series of policy advocacy activities and media appearances from LFMI in June and July provoked intense debates among decision makers, experts and the media. As a result, policy deliberations on the new draft law on leasing were halted. Presently, changes to the functioning legal basis are being considered.

1 5 Commercial banking

LFMI analysed the rules of opening and disposing bank accounts, concluding that they impose petty regulations on enterprises' relationships with commercial banks. These regulations had been introduced as a measure to control the holding of bank accounts. As a result of an extensive media campaign from LFMI, the Bank of Lithuania prepared a revised version of the rules of opening bank accounts. The Bank of Lithuania continues to work on this.

2 Fiscal Policy

LFMI's primary goal in the area of taxation is to promote and contribute to the replacement of the current tax system, seeking to minimize its destructive effects on economic processes and market participants, to reduce the cost of tax administration and to ease and even the tax burden. During the reporting period LFMI worked on the following issues:

- 2 1 a tax reform proposal
- 2 2 corporate and personal income taxes
- 2 3 charges on the registration of industrial property
- 2 4 stamp duty
- 2 5 state levies
- 2 6 lump-sum income tax on individual business activity
- 2 7 the tax administration and information systems
- 2 8 budget reform

2 1 A tax reform proposal

LFMI concluded a conceptual proposal for tax policy reform and an extensive dissemination campaign, including a major conference "Proliberal Reforms: Lifting the Tax Burden" and a series of policy advocacy events and media appearances. LFMI formulated the ultimate aim of the tax reform and coherent steps necessary to implement the reform in accordance with society's readiness for changes. The proposed principles of a tax system are of universal nature and instrumental in designing any changes in tax policy.

The centerpiece of the proposed reform is the removal of direct income taxes and a shift to a system comprising a VAT-based tax and trust-fund taxes charged directly on the recipients of public services. The use of direct income taxes alongside value added tax implies inefficient double taxation of the same objects. As compared to VAT, the main defects of direct income taxes is that they provide opportunities for direct government interventions in economic processes and are marked by complicated and costly administration. If charged without exemptions, value added tax prevents manipulations, it is easy to administer and is generally recognised as a man's tax.

After a long process of policy debates, the government has changed its approach to tax reform by switching from unsystematic decisions to planned policy actions. A Programme for Revising Tax Legislation has been adopted, incorporating almost all of the LFMI's proposed principles of a tax system. These include fairness, equality, economic neutrality, simplicity, transparency, and effective administration. This program is expected to provide a framework for major revision of the tax code in Lithuania. LFMI will continue its involvement in the policy debates to ensure the adherence to the adopted principles and sound policy changes.

2 2 Corporate and personal income taxes

LFMI exerted profound influence on the adoption of amendments to the functioning laws on corporate and personal income taxes as well as to the preparation of a new legislation on income taxation, which is scheduled to replace the existing laws as of the year 2000. In the process of debates on the amendments to the functioning laws, LFMI's proposals were adopted regarding carry-forward of losses, representation costs, income declaration, accounting methods for firms without the rights of legal entities, VAT deductions, exemption of income from other than primary business activities, etc. These changes brought about essential improvements to business conditions in Lithuania. However, the revision of the laws also comprised a number of provisions which were opposed by LFMI. These included the provisions on advance payment of corporation tax, accelerated depreciation, taxation of dividends, taxation of income received according to civil contracts, etc. LFMI will continue to influence the debates on the new legislation in order to help remove remaining fallacies and defects.

2 3 Stamp duty

LFMI submitted to the government a project of amendments to the stamp duty legislation, seeking that (i) stamp duties are paid by direct recipients of the public services for which stamp duties are charged, (ii) the size of stamp duties reflects the costs of public services, and (iii) receipts from stamp duties go toward financing the institutions that provide the services. The preparation of the policy proposal was prompted by a number of factors. Unfounded tariffs have been widely used as tools for regulating economic processes and curbing competition. Stamp duties charged on the issue of business licences have obstructed market entry, inflicted costs on budding businesses and stimulated the expansion of the shadow sector.

The proposal from LFMI was approved by the Economic Ministry, the Interdepartmental Council on SME affairs, and the Industrialists Confederation of Lithuania. The Economic Ministry is now in the process of preparing the proposed changes for formal submission to the government. This prospect is very likely to spur necessary policy actions to revise stamp duty regulations. As a result of the policy advocacy from LFMI, the government resolved to charge a uniform stamp duty for licences issued to passenger transportation companies and instructed the Economic Ministry to prepare an overall revision of the stamp duty legislation.

2 4 State levies

LFMI submitted, along with the proposal for the revision of stamp duty legislation, a policy paper urging to repeal all state levies and to charge stamp duties for all services provided by state institutions. LFMI's initiative was very timely given that the Finance Ministry had been instructed to draw a legislative proposal on state levies. LFMI commented on the new draft law and presented conceptual provisions on the issue. LFMI will take efforts to influence the policy debates on the draft law upon its submission to the government.

2 5 Charges on the registration of industrial property

The Ministry of Administrative Reforms and Local Authorities proposed a draft law introducing a state levy for the registration of industrial property. In a policy paper, which was presented alongside the recommendations for reforming stamp duty and state levies, LFMI noted that levies on the registration of industrial property are in their essence stamp duties and therefore should be replaced by stamp duties.

As a result, the ministry suspended the draft and drew a project of amendments to the functioning provisions regulating the registration of industrial property.

2 6 Lump-sum income tax

The Finance Ministry drew a proposal for revision of lump-sum income tax charged on commercial activities of natural persons. LFMI submitted a policy proposal, proposing that lump-sum income tax should be used to "buy out" the right to undertake commercial activity by natural persons. Lump-sum income tax was introduced in 1994 in order to provide conditions for income recipients to pay personal income tax without incorporating a firm and regardless of incomes received. The tax is differentiated for different business activities but is not envisaged for all possible areas of activity. It does not provide a possibility to pay personal income tax on income received from other natural persons.

LFMI participated in a ministerial task force to revise the draft law and will continue to advocate revision of legal provisions regulating lump-sum income tax with the view to enhancing the prospects of self-employment and improving business conditions.

2 7 Tax administration and information systems

The State Tax Inspectorate and the State Social Insurance Fund are proceeding with the consolidation of tax administration and information systems. A couple of years ago LFMI came out with a proposal to rebuild the information system as one key to limiting government and public spending as well as building a viable tax system. LFMI's recommendation was upheld by the prime minister, and the cabinet endorsed the unification of the tax information systems. LFMI continues to provide advice on how to unify the tax and state information systems in an efficient and consistent manner.

2 8 Budget reform

Over the past years, LFMI has advocated a comprehensive budget policy reform that would create conditions for curtailing redistribution, lifting the tax burden, increasing transparency of public spending, and providing conditions for a more efficient allocation of resources. In response to the pressure and policy advocacy from LFMI, the government launched work to revise the principles of budget formation and the Law on the Budget Structure drawing on the analysis and policy recommendations from LFMI. LFMI worked closely with a task force under the Ministry of Finance to prepare a new concept of budgetary policy. The concept drawn was approved by the government, providing for the abolition of 18 extrabudgetary funds, increased transparency, and program budgeting.

LFMI will continue to participate in the policy debates on the budget reform in general and the adoption of the next year's budget in particular to ensure that the principles approved are properly implemented in legislation and adhered to in policy actions.

3 Private Enterprise

LFMI's efforts in the area of private enterprise focused on

- 3 1 the Law on Joint Stock Companies
- 3 2 investment
- 3 3 control of enterprises

3 1 The Law on Joint Stock Companies

LFMI initiated revision of the joint stock company law in order to strengthen corporate governance and eliminate restrictions on enterprise borrowing and other business contracts. To achieve these goals, LFMI analysed the functioning law and prepared a package of amendments. LFMI's initiative received approval from the prime minister. LFMI submitted the project of amendments to a working group under the auspices of the president of Lithuania. The president sent the final version of the amendments for governmental consideration before its submission to parliament.

3 2 Investment

The Ministry of Economy drew up a legislative proposal on investment, which is to replace the functioning law on foreign capital investment. Analysis of the draft showed that its adoption would create conditions for political favouritism, create uneven playing fields for investors and complicate the legal system. LFMI urged the government to reject the draft and to encourage investment by improving the general legal and institutional environment for private business activity. As a result, the Economic Ministry drafted a new proposal, which was included in the government's program.

3 3 Control of enterprises

An intense dissemination campaign from LFMI put a stop to the Economic Ministry's proposal on the control of enterprises. According to the proposal, enterprises would be deprived of their licenses, and heads of the enterprises prohibited from running a business, for violations of law, such as "wilful" tax evasion or illegal trade, or losses incurred by the enterprises. The adoption of the proposal would undermine the rule of law, lead to unacceptable interventions in private business, invite corruption, and provide conditions for deliberate attacks on individual persons. LFMI's dissemination efforts led to intense public debates and a barrage of criticism of the ministry's proposal from the business community and the media. In response, the government returned the bill from parliament for further revision and confined its application to state-run enterprises.

Monetary Policy

The Bank of Lithuania worked out a Monetary Policy Programme which outlined monetary policy objectives and development stages for the coming years. The main objective is to phase out the currency board and to restore classical central banking. LFMI commented extensively on the implications and potential consequences of the new monetary policy in the media and various forums. LFMI continued to advocate reliance on strict, rule-bound monetary policy protected from political pressure as well as full backing of

money LFMI's media exposures received much response from influential political circles, the business community, and the public, indicating that the current monetary arrangement which is based on currency board principles and which was advanced by LFMI in 1993 had gained widespread support. In the wake of the crisis in Russia and its effects on Lithuania's economy, the Lithuanian authorities began to recognize that sound and credible money under a currency board system is the only anchor to avert difficulties and instability. As a result, a decision was made to preserve the current monetary regime until the year 2000.

Other Economic Policy Areas

Land lease

At the request of President Adamkus, LFMI evaluated a draft law on land lease and submitted a policy paper indicating the defects of the draft and proposals for its improvement. President Adamkus suspended the signing of the law and returned it to parliament for revision. After debates, the parliament adopted all recommendations proposed by the president. The parliament extended the term of land lease to 99 years, instead of 25 years proposed by the authors of the draft, on the point that such a short term would discourage private initiative and impede the development of economic activity. Also, the law was amended so as to remove possibilities to apply exemptions and privileges.

OUTREACH

LFMI actively utilised mass media in increasing the impact of policy recommendations and building community support as crucial elements in implementing and sustaining policy reform initiatives. The advocacy-type of dissemination activities generated 216 media exposures, of these 168 in print media and 48 on radio and television.

Appearances in print media The print media appearances consisted of 23 articles (one of them reproduced twice and one four times) authored by LFMI's policy analysts, five interviews, 81 comments, nine opinion columns, 11 policy proposals, six press releases, 32 mentions, and six reports on LFMI's events.

LFMI published in Lithuania's largest dailies *Lietuvos rytas*, *Respublika*, *Kauno diena*, and *Lietuvos aidas*, in the business *Verslo žinios* paper, the financial *Litas* paper, the *Vakarų ekspresas* daily, the *Apskaita ir kontrolė* accounting journal, the *Atgimimas* weekly, the Russian-language *Echo Litvy* and *Litovskij kurier*, the English-language *The Baltic Times*, the Russian-language *Biznes&Baltija*, the *Veidas* magazine. LFMI's articles were reprinted in local papers *Panevėžio balsas*, *Klaipėda*, *Šiaulių kraštas*, etc.

Appearances on radio and television Radio and television exposures comprised 23 appearances in live radio programs and 25 appearances on TV. LFMI appeared on *The Lithuanian radio*, *M1* and *M1 Plus*, *Radiocentras*, *Vilnius*, and *Znad Vilii* radios, *the Lithuanian television*, *LNK television*, *Tele-3*, *Vilnius Television*, and *Baltijos Television*.

NEWSLETTER

LFMI published four issues of the Lithuanian-language newsletter, *Laisvoji rinka*, and four issues of the English-language *The Free Market*. The newsletter highlighted the Institute's recommendations on emerging legislation and the latest trends in economic policy. It presented economic overviews on the reform process, articles on key aspects of economic policy, and comprehensive statistical data illustrating the progress of Lithuania's transition to a market economy. The newsletter was distributed to LFMI's subscribers, including business enterprises, governmental authorities, members of parliament, political parties, media, corresponding institutes, and foreign embassies. Additionally, the newsletter was distributed at LFMI seminars, workshops and discussions, which further increased the number of receivers. Articles from *The Free Market* were frequently reproduced in national dailies, business newspapers, journals and regional papers.

TRANSLATION OF "CAPITALISM AND FREEDOM" BY MILTON FRIEDMAN

LFMI, in co-operation with the Open Society Fund – Lithuania, published a Lithuanian translation of "Capitalism and Freedom" by Milton Friedman.

OPINION POLL

In the spring of 1998 LFMI carried out a seventh opinion poll among Lithuanian opinion leaders to elicit their attitudes to the emerging market economy and judgements on the ongoing reform process. The questionnaire was designed to follow up on previous polls to ascertain shifts in opinion and the proportion of people supporting free market solutions. The opinion polls targeted about 400 top policy makers, leading entrepreneurs, academics, reporters, and a cross-section of public leaders. The results were generalised and disseminated in the press. In addition, they are regularly presented in the LFMI's newsletter.